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ACTIVITIES OF THE TRANSNATIONAL CORPORATIONS AND MANAGEMENT DIVISION AND ITS JOINT UNITS

Experience gained in technical cooperation activities involving privatization and foreign investment

Report of the Secretary-General

SUMMARY

Privatization programmes are under way in at least 80 countries. Foreign participation can play an important role in these programmes. The report examines issues raised by privatization for the evolution of host country foreign investment policies. It discusses the economic and fiscal goals of privatization and the design of privatization and associated policies to enhance the contribution of foreign participation to those goals.

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INTRODUCTION

1. At its eighteenth session, the Commission on Transnational Corporations requested the Secretary-General to report to the Commission at its nineteenth session on experience gained in technical cooperation. The Economic and Social Council, in its resolution 1992/36, recognized the growing importance of privatization and associated policy and administrative reforms and stressed the important role that foreign investment can play in the process of privatization. The present report was prepared by the Transnational Corporations and Management Division of the Department of Economic and Social Development in response to the above-mentioned request.

2. The report draws on the considerable experience the Division has acquired in technical assistance and advice on foreign investment projects and arrangements, with particular reference to privatization. The Division has conducted advisory and training activities on aspects of privatization and foreign investment in some 20 countries. The report also draws on other world-wide experiences from both country-based and international sources.

3. Privatization is the transfer to private ownership or operation of commercial interests of the State. While many objectives are put forward, the core belief is that goods and services will be more efficiently provided by the private sector under competitive conditions. Governments have also sought fiscal benefits from privatization either in the form of cash from asset sales, reduction of debt or relief from ongoing financial support to unprofitable State enterprises. Indeed, in many developing countries, fiscal requirements have been among the most compelling short-term motives for privatization.

4. Broadly conceived, privatization can take a number of forms, including (a) the full or partial divestment of equity in State enterprises or sale of State assets; (b) the formation of new joint ventures, in which the State contributes its existing assets; (c) management or leasing arrangements for State assets; (d) contracting out-of-State services; (e) private finance and operation of new public facilities under arrangements such as build-operate-transfer (BOT); and (f) commercialization of government facilities for research and training.

5. Privatization is a comparatively recent economic trend in the developing economies but it has already become a world-wide economic phenomenon. It has recently been taken up by the transitional economies as an integral part of their transformation to market economies.

6. At least 80 countries have active privatization programmes and some 8,500 State enterprises world wide have been privatized over the past 12 years. 1/ The pace of privatization appears to be accelerating as most countries' programmes are in their early stages. Completed privatization transactions have been concentrated by region - the former German Democratic Republic accounts for two thirds of completed privatizations, while a small number of countries in Latin America account for nearly 60 per cent of all the privatizations in the developing world. 2/

7. Privatization has opened up many new opportunities for transnational corporations, including the following:

(a) Access to lower-cost production sources;

(b) Access to important new national and regional markets;

(c) Access to highly prospective mineral deposits;

(d) Opportunity for new business alliances.

8. For those transnational corporations that operate in global industries, privatization provides new pieces for global production linkages and market networks. For example, a key strategy in the acquisition of interests in overseas airlines or telecommunications enterprises may be to increase opportunities for the transnational corporation to participate in the external traffic. This may also be an inducement to international hotel chains. Many of the major privatizations involving transnational corporations appear to have been selective and strategic in this way. 3/

9. As yet, there are no comprehensive statistics on the contribution of foreign direct investment to world-wide privatization. 4/ In those countries with well advanced privatization programmes, such as Chile and Jamaica, a minority of transactions involved foreign participation. However, foreign investors targeted the larger transactions so the foreign investor contribution to privatization by share of value of total investments is more significant. In certain prominent transactions, the value of foreign direct investment involved is the equivalent of several billions of United States dollars. 5/ It is also the case that privatization has accounted for a large share of overall foreign direct investment inflows to some countries with advanced privatization programmes. Thus, privatization may act as a catalyst to increasing foreign direct investment and broadening its sources.

10. Sectorally, foreign participation in privatization has concentrated in manufacturing and public utilities, which have substantial capital and technology requirements. Telecommunications has a specially high incidence of foreign participation in privatization world wide.

11. It is possible that in the future there will be increased foreign activity in mining and petroleum privatization through joint ventures with state mining and petroleum enterprises. Also, foreign participation in the management and leasing of major State utility and infrastructure assets could spread. Investment in the expansion of these facilities through BOT schemes is likely to increase in importance as foreign investors gain confidence in the long-term economic stability of host countries and their capacity to assure access to foreign exchange from local currency earnings.

12. Host countries have much to gain by incorporating foreign participation in their privatization programmes. To realize these benefits it is necessary for privatization to take place under open and competitive market conditions supplemented by public interest regulation and intervention as necessary.

13. In many developing economies, urgent fiscal needs are driving privatization programmes under agendas that are heavily shaped by external creditors. This should not obscure the potential to realize important economic benefits from privatization and the associated policy and regulatory reforms. Many of the transitional economies are progressing to the point of separating enterprise ownership and control from the ministries in the largest enterprises that comprise the bulk of productive activity. Enterprises are being restructured to operate as market-oriented businesses. Foreign participation in various forms can be enormously supportive of the profound changes required for these enterprises to prosper.

I. FOREIGN INVESTMENT POLICY ISSUES IN PRIVATIZATION

14. In recent years, host country policies towards new foreign investment have become substantially more welcoming, and many Governments have implemented significant improvements in the national climate for foreign investment. Privatization offers significant additional opportunities for foreign participation - both in those industries traditionally targeted by foreign investors and in a range of "newly open" industries.

15. Might the enlarged scope for foreign participation afforded by privatization cause Governments to revisit their foreign investment policies? Also, are new issues raised in respect of the enabling conditions or "investment climate" for foreign participation?

16. Foreign investment has already been instrumental in the privatization of a number of large State enterprises in both the developing and the transitional economies. These cases have received considerable attention. However, they are probably not representative of the current thrust of most privatization programmes. Most countries' programmes are at the early stages, where typically small to medium-sized enterprises are put forward for privatization in the expectation that they can be readily transferable to domestic private sector ownership.

17. Yet, as privatization proceeds, much larger enterprises will be candidates for divestment. Their present size, let alone the capital needs for new investment, may exceed the absorptive capacity of local capital markets. Local management, technical skills and marketing connections may be in short supply. The role of foreign participation will come into sharper focus.

18. Privatization is at a relatively early stage in most developing and transitional economies. Yet, in these countries (as in many developed countries) there is some evidence that Governments are already exercising caution in respect of the scope of foreign participation in privatization. A number of quantitative measures are being applied to directly affect the balance between local and foreign ownership in enterprises to be privatized. (It is also possible that some Governments have chosen not to privatize certain enterprises because, realistically, the only feasible private acquirers would be foreign investors.) These measures include:

(a) Limitation of foreign owners' share of equity capital. For example, Malaysia places a 25 per cent limit and further requires diffusion of foreign

ownership in strategic enterprises so that no one foreign investor is dominant. Brazil has restricted foreign ownership to 40 per cent;

(b) Retention of the State's interest through joint ventures for rehabilitation or expansion;

(c) Exclusion of foreign investment from highly sensitive sectors (e.g., television and defence industries);

(d) Reservation of significant State ownership - possibly for eventual sale to citizens when conditions are propitious. Hungary, for example, seeks to withhold in State ownership an average of 25 per cent of the share capital of larger enterprises. This measure appears to be directly aimed at forestalling high levels of foreign ownership.

19. Why would Governments wish to place limits on the share of foreign participation in privatized industries (or to avoid privatizing certain enterprises because it might lead to foreign participation)?

20. In the first place, there is an understandable natural caution. It is already clear that organizing a national privatization programme is a demanding political and technical exercise. In any substantial privatization programme, a significant percentage of economic activity will be shifted from State to private provision, often under new "rules of the game". Governments are acutely aware that in economic changes of such magnitude there will be for long periods "winners" and "losers" among different population groups. In this situation, foreign participation has to be introduced in a sensitive and careful manner because privatization will certainly mean, in the short term, that the aggregate stake in national economic activity owned by or on behalf of citizens will be reduced in favour of foreigners. 6/

21. More fundamentally, Governments may consider whether privatization presents new questions about the important issues of sovereignty, local participation and control which arise in setting foreign investment policy. These questions are addressed below.

A. Sovereignty, ownership and control

1. Scale of foreign involvement

22. Privatization in principle opens more sectors of economic activity to foreign participation. Privatization may therefore revive concerns that foreign participation may come to play a too pervasive and influential part in economic life.

23. Is it likely that privatization will open the floodgates to foreign investment on a scale that is not consistent with economic sovereignty in either the developing or the transitional economies?

24. It should be noted that, over the past two decades, in no developing region has foreign investment accounted for more than 5 per cent of gross domestic capital formation. In the second half of the 1980s, foreign

investment accelerated but it appears that it is only in a few individual countries (such as in countries rich in mineral resources and Asian newly industrialized countries) that foreign direct investment accounted for over 15 per cent of gross domestic capital formation. 7/

25. Since in the developing countries the public sector typically accounts for about 10 to 20 per cent of economic activity, these statistics suggest that it is most unlikely in the developing countries that even comprehensive privatization could result in statistically high shares of ownership by foreign investors.

26. In principle, privatization affords greater scope for significant foreign penetration in the transitional economies. This is so because the State can account for over 90 per cent of economic activity prior to privatization. Also, a shortage of business skills and institutions and underdeveloped financial intermediaries may handicap local participation in divestments.

27. Despite the very early stage of privatization in the transitional economies of Central and Eastern Europe, there is already some sensitivity to the issue of the scale of foreign ownership. Hungary has privatized one fifth of State property and 7 to 8 per cent of the economy is foreign-owned. 8/ If this statistical relationship were maintained for the remainder of the privatization programme, it could result in comparatively high levels of foreign ownership.

28. It seems probable that a relatively high share of foreign ownership is itself a transitional feature of the transitional economies. With the development of a local market-oriented business culture and supporting institutions there is some reason to suppose that the share of foreign ownership will decline over time.

29. It has to be questioned whether, in any case, the supply of foreign investment will be forthcoming in volumes that might be troublesome to host countries. One indicator may be found in the largest single privatization programme that has taken place - in the former German Democratic Republic. There are special features such as the role played by investors from western Germany. However, of the first 4,000 enterprises sold, only 176 were acquired by non-German buyers despite the instant access to economic stability and a substantial national market afforded by unification. 9/

30. The new opportunities for foreign participation offered by privatization may, however, lead to concentrations of foreign influence in certain industries.

31. First, privatization could be a catalyst for high levels of foreign participation in particular export-oriented sectors and industries where foreign direct investment is already concentrated, especially in the developing counties. Natural resources and manufacturing are the most likely cases.

32. Secondly, privatization could involve high shares of foreign direct investment in the "strategic" industries that hitherto were expressly closed to foreign investment in the developing as well as in the transitional economies. Governments may consider this too intrusive, especially when it occurs in the

strategic industries that were originally placed in the public sector because of their sensitive nature.

33. These strategic industries include public utilities such as telecommunications and electricity generation, key infrastructure such as roads, railways and ports and, sometimes, service industries such as banking and airlines.

34. There would appear to be considerable scope in selected and strategic industries for the foreign share to be quite high. This is especially likely to occur if the domestic capital market is undeveloped or weakened by inappropriate macroeconomic policies and where local business skills are in short supply. Many of the privatizations in the above-mentioned sectors in the developed countries and in Latin America and Asia incorporated substantial local participation. In these countries, the supportive framework was in place. This supportive local business framework is less developed in the transitional economies and elsewhere in the developing world.

2. Opportunity for local participation

35. In many cases, Governments recognize that well-structured foreign participation can contribute to better capitalized, more efficient and dynamic industry. But, at the same time, it is recognized that past pervasive State ownership may have stunted local entrepreneurship and private ownership.

36. It may therefore be an important objective of a privatization programme to ensure full opportunity for local involvement in divested State interests. Indeed, the development of a market-oriented business and property culture may be an integral objective of the privatization programme such as in the transitional economies. In these circumstances foreign participation is likely to be assigned a supporting rather than a central role.

37. Associated concerns may be that poor local business conditions and undeveloped local capital markets mean that locals will not have the opportunity to make a meaningful bid and may indeed lose an opportunity which it will be impossible to retrieve once a foreign investor becomes entrenched. (A variation of this concern is that privatization may afford too much opportunity for an affluent minority group among the local population to increase its economic dominance.)

38. Such perceptions may become quite intense if the privatization process is perceived to result in sales of State assets or interests at concessional prices to foreign participants because of their ability to pay in hard currency.

39. All these issues can be termed problems of perceived "crowding out" of local private involvement by foreign participation in privatization. Privatization will present crucially important policy challenges to Governments to develop modalities of privatization that are participatory and developmental for local business and investment and for the retention of highly skilled personnel.

40. One strategy may be to limit foreign investment in, or defer privatization of, key State interests until local business interests and investors are better equipped to participate. Some Governments may be attracted by this approach, although it might severely delay the effective privatization of large State enterprises. Another approach to sustaining local involvement is to retain significant State ownership in new joint ventures with foreign investors. This does not seem a promising way of promoting the goals of private domestic business development and investment. A more promising alternative strategy may be to seek foreign participation in forms and on terms that themselves foster the development of local institutions and skills.

41. Some positive methods are being applied to handle possible crowding out problems and to make foreign participation complementary rather than competitive with local business and investment goals.

42. One method, which has been used in both developing and transitional economies, is to arrange concessional acquisition schemes for citizens. These can take the form of discount share prices, credit for purchases, or deferred payment schemes. These are efficient schemes in that the public subsidy is targeted directly at the objective of promoting citizen ownership. Typically, these schemes do not necessarily account for a majority of the share capital in an enterprise to be privatized - even where additional concessional schemes are available for workers and retired workers. Thus, they do not preclude foreign investors from acquiring a major initial stake or the enterprises from subsequently raising capital internationally to finance new investment.

43. A second method to ameliorate problems of crowding out is to spin off business activities from the main enterprise in a format that makes them accessible and attractive to local business. This can be a useful method with large utilities which, as a whole, may well exceed the absorptive capacity of the local capital market. In preliminary advice on the privatization of a telecommunications State enterprise, the Division identified repair and installation functions and other support services as suitable for divestment to local business. On the basis of long-term contracts with the telecommunications entity, these could be established as bankable business projects. Part of the performance requirements of the foreign investors in these cases will be to give training and support to these businesses to keep up with the introduction of new technology.

44. Further innovation will be needed to devise methods of foreign participation that are complementary to the development of local business development and private ownership.

3. Issues of national control

45. In the preceding subsections, it has been argued that privatization is unlikely to contribute to levels of foreign participation that threaten national economic sovereignty, although there may be a high concentration in particular industries. Does privatization lead to special issues of enterprise regulation and control that would justify limiting the access of foreign investors to certain kinds of enterprises to be privatized?

46. Developing countries have developed a maturity in dealing with the policy issues involved in obtaining mutually beneficial foreign investment sectors where they are traditionally concentrated, such as in manufacturing and natural resources. It is not readily apparent why the degree of foreign ownership in a sector would affect Government's ability to regulate and negotiate to advantage. Experience in these sectors suggests that significant local or State ownership is not necessary, or even sufficient, to achieve regulatory control. Further, the transitional economies can obtain, through technical cooperation and other means, access to extensive international experience in introducing substantial foreign involvement to such sectors.

47. For both sets of countries, the main issue is likely to be foreign participation in privatizing the strategic "newly open" industries. In these industries, foreign direct investment is comparatively new and untried world wide and there is less predictability about its consequences. At the same time, foreign participation in industries may bring the greatest economic benefits through the supply of capital, technology and markets that cannot be fully accessed through continued domestic ownership.

48. In summary, foreign investment policy is likely to be challenged but not threatened by the additional foreign participation arising from privatization. The overall scale of foreign involvement is likely to be within international precedents, although in the transitional economies, in particular, it will reach unfamiliar levels. Foreign involvement may be concentrated in certain industries. Some of these will be "newly open" strategic industries that present regulatory issues. However, it still seems to be the case that limiting foreign participation is unnecessary to achieve public interest controls. More important, privatization will take place in many countries with a rudimentary or stunted domestic private sector. A challenge for foreign participation is for it to be complementary and supportive of the development of local business and ownership.

B. Enabling conditions

49. Privatization does not on the whole present special issues in attracting foreign investment compared with greenfields investment or any other foreign direct investment activity. Foreign investors will in any event have a number of concerns that may sometimes go beyond those of local private investors, for example:

(a) A legal framework that is conducive to businesslike decisions and outcomes, including respect for the rule of law;

(b) Ability to take effective control and exercise management autonomy;

(c) Stability or at least predictability of the rules and policies;

(d) Non-discriminatory treatment;

(e) Impartial dispute resolution;

(f) Non-prohibitive fiscal treatment;

(g) Reliable access to foreign currency.

50. During the 1980s, there has been increased recognition by developing countries of these and other important "investment climate" issues. Economies in transition have only recently had to grapple with them outside the somewhat artificial environment of the State/foreign enterprise joint venture laws and free economic zones. Thus, the challenge to provide minimum enabling conditions is especially acute in the transitional economies. This applies in particular to the development of foundation business laws, appropriate sectoral laws and supporting business and financial institutions.

51. Governments of the transitional economies are fully aware of the importance of developing these foundation laws, policies and institutions. Unfortunately, it is quite common to see rushed attempts to produce documents such as business laws. Often, these are unsatisfactory and have to be revised repeatedly, which causes confusion to investors. In one transitional economy in which the Division has advised, there have been three versions of the foreign investment law in the past three years. Meanwhile, there have been uncoordinated and thus confusing attempts by multilateral and bilateral agencies to assist the Government in drafting a company law.

52. These problems often stem from a lack of technical knowledge in the host country combined with pressures to meet unrealistic timetables. In other cases, the changeability of government positions on key investment issues reflects either intense policy debate or unresolved constitutional issues concerning the jurisdiction of regional and local authorities.

53. While there is uncertainty about the durability of laws and policy, privatization transactions involving foreign investment may be unduly confined to those that can be the subject of virtually self-contained contracts (such as in the mineral resources area). Alternatively, foreign participants may minimize their risks in an uncertain environment by seeking management or leasing arrangements rather than capital participation. This will not always suit Governments seeking new capital formation and improved technology as a key benefit of privatization.

54. An important aspect of the investment climate is reorganization of the operations of State enterprises and supporting business practices and institutions so as to make them more suitable vehicles for foreign participation, where that is desired.

55. The transitional economies (in particular those of Central and Eastern Europe) are now at a critical stage of enterprise reorganization - the legal incorporation of State enterprises, separation of their ownership and control from the ministries and their preparation to perform as businesses in a market economy. Essential steps include the following:

(a) Organization of the enterprises - installing capable boards, competent management and sound business practices, including new accounting standards;

(b) Development of business plans which may include links with foreign investors for capital, markets and technology;

(c) Continued development of appropriate sectoral policies, capital markets and financial institutions and capacity of the ancillary business professions.

56. In the market economies, the existence of much of this capacity is taken for granted. In the transitional economies, especially in Central and Eastern Europe, there are major gaps in the above-mentioned areas and the need for programmes of unparalleled scope and speed to fill them.

57. Technical cooperation programmes have much to offer in training and advisory activities at the level of enterprise reorganization, formation of new business relationships (including those with foreign investors) and the required legal, institutional and professional environment for business. The Division, for example, conducts training programmes in financial and management accounting in the newly independent States of the former Soviet Union. These train board directors and company managers in reformulating accounting information to acceptable international standards. This provides a foundation for preparing valuations for new investment and financing proposals, especially where foreign investment and financing is being sought.

58. In summary, privatization does not necessarily raise new issues with regard to the general enabling conditions for foreign investment. But Governments seeking a broad-based increase in capital formation through privatization will need to intensify their efforts to improve the enabling conditions for foreign investment.

II. ORGANIZING PRIVATIZATION AND THE ROLE OF FOREIGN PARTICIPATION

59. Privatization is taking place in a world economy that has changed since enterprises were first taken into public ownership. Inward-looking development strategies in which the outside world was walled off to permit domestic business capacity to grow are no longer seen as optimal. The fastest growing economies are those that seek ways to participate openly in the global economy through investment and trade. Foreign participation can have an important role to play in outward-looking growth strategies by bringing capital, technology and markets to developing countries.

60. Most privatization programmes contemplate some role for foreign participation. The precise role that it plays depends in part on the goals of the overall privatization programme. For example, if privatization is seen by a Government as largely an exercise in unburdening itself of financial and management responsibilities, foreign investment is likely to be seen primarily as a fiscal revenue source. If the goals of privatization are more widely defined to include lifting the rate of economic growth, foreign investment may be seen as a more dynamic, economic force, especially if privatization is part of an economic liberalization strategy.

61. What are the important issues in designing and implementing privatization programmes so as to incorporate and optimize foreign participation? Four interrelated issues stand out: how foreign participation might improve economic gains of privatization; how it might contribute to economic loss; the

special issue of the entry price for foreign investment; and, finally, the role of incentives to encourage foreign participation. These issues are considered below and in section V dealing with modalities in privatization transactions. The overriding conclusion is unsurprising - foreign participation can make a distinct contribution to privatization but will only be beneficial in so far as privatization is accompanied by appropriate general policy and regulatory reforms and improved government capacity to implement them.

A. Sources of potential economic gains

62. Foreign participation can contribute to economic gains from privatization in a number of ways:

(a) Improved technical efficiency of the enterprise;

(b) Access to larger markets, including foreign markets;

(c) New capital formation;

(d) Supply of improved technology.

63. In principle, government or domestic private owners could acquire or organize these for themselves, without inviting foreign participation. However, transnational corporations often have a comparative advantage in one or more of these aspects. Also transnational corporations may be superior providers because they are better able to bundle together all these related inputs and deliver them to enterprises of large size and complexity. In these cases, foreign participation will potentially improve the economic impact of privatization.

64. There is currently some indication of these impacts in completed privatizations. Two caveats should be borne in mind in considering some cases. First, completed privatizations are so recent that experience to date deals only with the short-term impact. Secondly, change in ownership or management is usually one aspect of a number of matters that change upon privatization and affect future performance. For example, it was often difficult for State-owned enterprises to function efficiently in a climate of numerous and conflicting policy objectives.

65. The Division recently reviewed the impact of partial privatization on the technical efficiency of port services in an African country. Several competing port services companies were formed to take over port services from the Government. Some of the new entrants were fully foreign-owned and some were joint ventures with local interests. Each had foreign management. After four years of private operations, significant technical performance improvements were evident. Average cargo throughput per hour doubled during the period and, partly as a result, new business was attracted to the port, which recorded a 300 per cent increase in cargo volumes.

66. Recent reviews of port and utilities privatizations elsewhere also report gains in technical efficiency following privatization with foreign participation.

67. Access to larger markets, especially foreign markets, is likely to be a key comparative advantage gained from foreign participation. This is especially the case where the transnational corporation itself controls an international network of suppliers. For example, in a case in which the Division advised on the partial privatization of a State manufacturing enterprise in Africa, the successful bidder proposed to increase investment and production substantially so as to export feedstock to its operations in other regional countries.

68. Access to capital and associated improved technology was of central importance to the privatization of Skoda, the Czech and Slovak State-owned auto company in 1991. Volkswagen, the German auto company, acquired 100 per cent of Skoda and committed additional investment totalling $6.4 billion over the following 10 years. 10/

69. The Division recently advised the Government of a small country on options for privatization of the State telecommunications enterprise. The present system was lagging both in services and in application of modern technology and was an impediment to economic growth. Only two persons per hundred had a telephone; many thousands of applicants were awaiting telephones despite an installation fee many times the regional norm. On average, only one half of the international calls were completed. It was estimated that the investment required to install digital services and achieve service coverage on a par with the competing regional countries was over US$ 1 billion. This investment was beyond the resources of either the public or the local private sectors and their capacity to access international capital sources. Clearly, well-structured foreign participation could make a significant economy-wide contribution in these circumstances.

70. As these examples illustrate, there may be significant benefits available from foreign participation in privatization. However, Governments will also need to consider the environment in which privatization may be associated with net economic costs, as considered below.

B. Sources of potential economic loss

71. Foreign participation in privatization can, in general, be associated with the imposition of net economic costs from three sources:

(a) Inappropriate economic policies;

(b) Inadequate regulation when public and private interests diverge (e.g., in the monopoly-prone industries);

(c) Fiscal loss through underpricing the divestment.

72. It is important to note that, in respect of the first two matters (policy and regulation), economic costs can arise from privatization transactions irrespective of the form or level of foreign participation, if any. Further, they are avoidable by careful policy and regulatory development prior to deciding on the form of disposal of State interests. Experience shows that this is not always the case, especially when privatization is undertaken in a

piecemeal fashion or is motivated primarily by government fiscal aims. An example of the problems that can arise is given below. It is only with respect to fiscal loss through underpricing that foreign participation may uniquely lead to economic loss. This probably accounts for the widespread attention that has been given to valuation and competitive bidding arrangements in privatization.

73. Inappropriate economic policies distort market prices and lead to investment and production decisions that may be commercially attractive but are not in accordance with a country's economic interests.

74. Consider, for example, the potential economic cost of privatizing a State enterprise in an industry that is not internationally efficient and depends on import protection for its financial survival. Suppose that no amount of increased investment, improved technology and greater management efficiency brought by a foreign investor will enable the enterprise to be profitable without that protection. If the Government rules out liquidation of the enterprise (perhaps because of its sunk investment or its employment contribution), foreign participation will contribute to net economic loss for the community. Further, foreign investors are likely to seek contractual assurances of continued long-term import protection that will entrench the problem.

75. Truly awkward issues arise in these circumstances as the Division has found in advising Governments in such cases. One case involved privatization of a State agriculture enterprise that partly supplied the local market, assisted by an import quota. A policy dilemma arose between imposing new investment obligations on the buyer and not wishing to expose the economy to further welfare loss by boosting production of the high-priced local product. A second dilemma arose between imposing high economic cost through substantial continued import protection (to boost profitability) and obtaining a high divestiture price.

76. It is likely that a great many cases of economically inefficient enterprises are yet to be addressed in privatization programmes throughout both the developing countries and the economies in transition. As the example illustrates, it is important that an overall industrial and trade policy be developed to govern the privatization programme.

77. The second source of welfare loss can arise where public and private interests diverge and are not controlled by adequate regulatory systems. Possible instances include environmental and public health and safety matters and consumer protection in the case of monopoly-prone industries. Frequently, these matters were dealt with by the internal regulatory mechanisms of the State enterprises themselves. With privatization this is less appropriate. Governments will need to establish separate and perhaps independent regulatory bodies for public interest regulation.

78. A trend in the programming of privatization in both the developing and the transitional economies, which the Division has encouraged in its advisory and training work, is to commence privatization with small to medium-sized enterprises. These fit more easily into market-oriented competitive industries and present fewer specific regulatory issues. More time can then be taken to

develop industry-specific regulation to govern the operations of the larger and strategic enterprises. This will give an opportunity for Governments to devise frameworks that make sense for the national economic interest and also make business sense for investors.

79. Nevertheless, the sequencing of privatization should contain a window that enables selected major enterprises to be privatized on a one-off basis with a carefully defined role for foreign investment. Telecommunications is a good example in which regulatory reform, full or partial divestiture, large-scale new investment commitments, and substantial fiscal inflows can be bundled together in a separate privatization package.

C. Entry price

80. In the public perception, the most obvious potential for economic loss from foreign participation arises from underpricing the disposal of the State's interests - whether this takes the form of acquisition of an asset or interest, the participating interest gained from contributing State assets to a joint venture or the value of lease payments. When a non-resident investor pays below maximum financial price for an interest this is a transfer across borders and an economic loss for the host country. An underpriced sale to a domestic investor is a transfer within borders and does not result in economic loss, though it may raise questions of fairness (especially if the sale is to an affluent minority group).

81. It is therefore in the public interest that (a) privatization transactions be accompanied by sound financial valuation of the interest prior to disposal, and (b) the process is conducted in a competitive manner likely to maximize the State's financial return given the parameters of the tender.

82. Financial valuation of State enterprises and assets is often not a straightforward task (for either Governments or potential foreign investors). Performance projections are complicated in many countries by pronounced uncertainties about the future commercial climate. There may also be problems with the availability and quality of historical financial information. For example, in the transitional economies, there is often a lack of historical information prepared in accordance with internationally accepted accounting standards. Technical valuation problems were described in a report submitted to the Commission's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting at its tenth session (E/C.10/AC.3/1992/5).

83. A number of misgivings underlie the concern of underpricing. Governments sometimes have unrealistic goals in pricing asset sales or deciding on minimum acceptable returns from joint venture arrangements - for example, that the sale of a business must at least return the accumulated value of Government's capital expenditure as owner, or at least pay off the enterprise's debts, or at least enable all severance and pension obligations to be met. However, commercial value depends on future not past performance. Proper valuation procedures will demonstrate fair value. This may be much lower than purported asset value or enterprise net worth. Given the sensitivity of the issue, it

may help to have independent valuations, especially where foreign investors are likely to participate.

84. However, there is a further concern that assets will be underpriced because current economic dislocations produce such a "buyers market" for foreign investors with hard currency that there is an intrinsic bias that is not readily overcome by available valuation methods. A key privatization official of a major transitional economy has commented that a Western student working during summer vacation could earn enough to buy an entire plant in his country. This comment exemplifies a concern that the Division has noticed in training workshops.

85. Asset values are based on expected future commercial performance. Governments that believe that assets are currently "too cheap" take a more optimistic view than foreign investors of future economic conditions. Governments with this view may delay or limit privatization until expectations improve. This ignores the catalytic effect that completed privatizations themselves have in improving the perceived economic climate. Moreover, if privatization's essential goal is to put State assets to more effective economic use, delays will not be in a host country's wider economic interests.

86. Some case-study evidence is now emerging that shows how the economic importance of the cross-border distribution of the gains of privatization, while significant, can be outweighed by direct economic effects. Foreign acquirers of interests in Telmex, the Mexican telephone company, certainly profited from its privatization. But a recent study calculates that privatization produced substantial economic benefits and provided a net gain for Mexico. 11/

87. Overall, it can be argued that the strongest source of benefits to be gained from privatization are not likely to be fiscal. The benefits are to be found in improved enterprise management and better allocation of resources, including the introduction of new investment, technology and markets and provision of lower-cost goods and services in the economy.

D. The role of incentives and performance requirements

88. It is rare for a privatization programme to mandate special incentives for foreign investors. Foreign investors can avail themselves of any relevant incentives at their disposal in the foreign investment law or those available in the country generally for qualifying investment from any source. These general incentives typically apply only to activities in which there is new capital formation. Thus, it is unlikely that foreign participants in privatization could, as a general rule, obtain incentives merely for carrying on business as usual.

89. Non-privatization specific incentives may apply to any new capital formation arising. This is the course taken by the Division in advising on an agro-industrial privatization in Africa. It was suggested that the Government offer the accelerated depreciation allowances available in the investment promotion legislation but only on assets acquired subsequent to the privatization.

90. The role of debt/equity swaps as an incentive device has attracted some attention in the context of privatization. A debt/equity swap enables an investor to obtain local currency for an equity purchase in exchange for releasing the country from a foreign debt obligation. An incentive for the investor can arise from a combination of a discounted secondary market value of the debt, the amount of this discount to face value retained by the Government on conversion, and the exchange rate applied to the transaction. The benefit is a lower start-up capital cost or lower acquisition price. Swaps can be applied to either new private investment or state divestment and in principle can be available to both domestic investors with access to foreign exchange and to foreign investors.

91. Quite extensive use of debt/equity swaps has been made in several Latin American countries and in the Philippines, although relatively few of these have involved foreign participation in privatization. They were chiefly used to finance new enterprise or the expansion of existing private business. A number of questions have been raised about the merits of debt/equity swaps, including their impact on monetary growth and inflation and whether they have induced new investment or simply benefited investment that would have taken place in any event.

92. There is no doubt that Governments could make debt/equity swaps a powerful tool in promoting privatization if discounted debt to commercial banks is available. By choosing to retain little of the debt discount and offering an attractive exchange rate on debt/equity swaps a Government could offer large effective reductions in the divestment price of State interests. But it could do so just as easily by offering a discount directly and using the divestment proceeds to purchase its external debt paper. Debt/equity swaps are therefore a means of maintaining a high apparent divestiture price while indirectly offering an attractive price to the incoming investor. This procedure may be a more publicly acceptable way of offering an attractive deal.

93. On the whole, the prevailing practice is not to mandate special incentives for foreign participation in privatization. This is consistent with current trends in foreign investment policy which include equal treatment of national and foreign investors undertaking similar investments.

94. Nevertheless, any privatization transaction offers considerable scope for providing project-specific incentives. These can take the form of cost reductions (such as direct and indirect measures to lower the acquisition cost), in which the subsidy is from the Government. Or incentives can take the form of revenue enhancements (such as measures to control competition or regulate sale prices), in which any subsidy is likely to be from consumers. By targeting incentives on a case-by-case basis, Governments are able to link incentives to performance requirements such as investment and output targets. Indeed, it is quite common for Governments to set key performance requirements as conditions of the privatization - so that the entry price becomes a residual matter, albeit subject to competitive bid.

95. The Division was asked to review the quasi-privatization of the electricity, water and sewerage utilities in a country in Africa. Private companies were invited to tender for the leasing, operation and maintenance of the state facilities. Detailed performance requirements were set out in

contractual form in the tender documents, including the rate adjustment formulas for the 10-year lease period. The sole bid variable was the private operator's share of the consumer charges. The case of Telmex, the Mexican telephone company that was privatized in 1990, is a further example. The privatized entity was offered a monopoly on local services until 1996 and on long-distance services until 2006. Service rates were raised prior to the privatization and a long-term rate adjustment formula established. Detailed performance requirements were established, including expansion of the number of lines in service and the number of public telephones; maximum waiting times for installation were set and it was stipulated that all towns with over 500 inhabitants should have a telephone service by 1994. 12/ Arguably, the incentives provided in this case were the rate hike and protection from competition not in the form of fiscal incentives or an entry price discount (i.e., any subsidy came from consumers not from Government).

96. In monopoly-prone industries such as the public utilities cases cited above it is perhaps inevitable that wide-ranging performance requirements will be imposed on regulatory grounds. This is also occurring in respect of commercial outcomes. In a recent mining privatization case in Latin America, minimum throughput and processing requirements were set as conditions of the invitation to form a joint venture with the State. The tenders were to be judged on the per cent participation offered to the State by qualified bidders. In this case, the "price" (i.e., per cent of the joint venture offered to the State) was the variable that offered the required incentive to the investor.

97. The key benefits of privatization are likely to be found in economic gains through increased investment and output, new markets and improved technology. But this does not necessarily mean that Government should stipulate such commercial outcomes as entry conditions. Within the appropriate policy framework, scope should be left for potential investors to propose business plans that they believe make the best commercial use of the assets. At times, it may be appropriate to give contractual form to these proposals, especially where some form of incentive is involved.

98. In principle, however, it would seem contrary to the philosophy of privatization for Government to attempt to predetermine commercial outcomes over and above those that are required to meet regulatory standards.

III. REGULATION AND PRIVATIZATION

99. Privatization is sometimes seen as being the same thing as a reduced role for Government. This is only true in terms of the business investment and management activities of Government. Otherwise, privatization in fact requires a strengthening of Government - in its role and ability to be a regulator.

100. Where privatization occurs in industries that already contain private commercial activity there may be only a limited range of new public policy matters to attend to. For example, if the State enterprise was originally mandated to provide more competition, privatization should not present new regulatory issues. The focus will be more on the modalities of the transfer to ensure that the transfer to private hands does lead to a thriving firm. This may be difficult to achieve if the potential buyers are likely to be one of the

existing firms. A new foreign entrant can be helpful here even if the other firms are already foreign-owned.

101. More delicate matters arise if the privatization candidate was originally established to provide one firm in an industry that would be "sensitive" to local needs. Such a need was felt, for example, in banking in the newly independent countries. Colonial-era banks were thought to focus largely on financing the expatriate business community and not to service the local community effectively. But irrespective of privatization it will be important for the Government to develop policies that address the performance of all firms; thus, privatization itself does not present new regulatory issues. However, the opportunity can be taken in the privatization process to assess the likelihood that candidates will serve policy objectives.

102. However, where privatization is to take place in an industry previously served by a public monopoly, much regulatory strengthening and specific government intervention will be needed. The privatization of monopoly-prone industries, such as public utilities and infrastructure, for example, will require both consumer protection regulation and specific measures to address the needs of poor or remote communities.

103. In the economies in transition, it will require considerable effort to disengage ministries from their business functions and to accept a less embracing but none the less important role of regulator. In advising one transitional economy on new regulation for an important sector, the Division found the responsible ministry to be functioning as little more than the corporate headquarters of the State sectoral enterprises. The ministry's views on sectoral policy reform were strongly influenced by the State enterprises' desire that the reforms provide, by statute, for their free equity participation in all new ventures with private investors. This was to be balanced by fiscal concessions so as not to create a disincentive for private investment. The recently adopted foreign investment law of that country mandated substantial tax concessions to foreign investors. Such tax treatment may have been designed to enable State enterprises to negotiate benefits from joint venture deals over and above their capital contributions.

104. In principle, the greater the competition that Government can stimulate in an industry the less its regulatory burden. Foreign investment can help by increasing the competitive alternatives. It is important to note that foreign investment does not present new regulatory issues for Government over and above those that occur with foreign investment outside the privatization context. These issues are primarily fiscal (ensuring that the foreign-owned enterprise is a genuine profit centre and tax contributor within the host country) and technological (ensuring transfer of technology and training).

105. There is a need, however, for technical cooperation programmes to transfer experience in these matters to those countries that are only now beginning to encounter foreign investment on a significant scale.

IV. MODALITIES IN PRIVATIZATION TRANSACTIONS: SOME ISSUES

106. Whether in the transitional or the developing economies, the bulk of foreign investment is likely to be in larger transactions, those with special sectoral issues (such as natural resources) and in the monopoly-prone industries. Such transactions will be sizeable enough to justify a case-by-case approach to privatization.

A. Where to decide policy issues

107. Privatization can be seen as a catalyst for useful changes in economic policy and other factors that improve the investment climate. However, it is sometimes the case that Governments expect the chemistry to work at the bidding and negotiation stage. No matter how skilled negotiations may be, they are not the place to set national policy. They can at best only provide greater clarity and certainty as to policy. Policy decisions should be made prior to inviting proposals and should form part of the bidding environment. Otherwise, it proves extremely difficult to get comparable proposals and the perceived fairness and transparency of the process will suffer.

108. For example, the Division advised on bids received for the sale of 49 per cent of an industrial enterprise in Africa. The enterprise was a monopoly enjoying import protection. It sold virtually all output on the local market under rigid price controls and with considerable uncertainty about access to foreign currency at a highly overvalued exchange rate. The two leading bids varied in price by a huge margin. One bidder assumed that current policy would continue and sought to negotiate contractual assurances about its continuity. The other bidder assumed that current arrangements were unsustainable and based its price on estimated profit to be made by requiring that a small proportion of the product could be exported for hard currency. A more credible process would have fixed policy with respect to import protection, price control/competition policy, freedom to export and other policy matters prior to the invitations to bid.

B. Tender process

109. It is important that privatization is conducted through a transparent and competitive process to lead to a fair value transaction. Unfortunately, there are cases in which modalities of privatization are overly governed by the rules of public procurement, such as those that pertain to public works contracts. In this approach, the Government seeks to closely define performance requirements and reduce the tender process to little more than a comparison of offer prices for the State's interest. Recently, the Division was asked to advise on the form of tender documents in which the text of a proposed contract was annexed to the tender invitation. All tenderers were asked to post a bond that bound the winner to sign the contract substantially in the form proposed.

110. This kind of procedure overemphasizes transparency at the expense of encouraging innovative business proposals, including new investment, which potentially are the key benefit from the transaction. Governments may not be wise to assume that they know best the future directions of the enterprise,

especially where the enterprise has not been exposed to export opportunities or state-of-the-art technology. In most cases, bidders should be invited to propose business plans under general guidelines that should include such matters as:

(a) Ability to access new markets, including export markets;

(b) Willingness to undertake new investment to increase efficiency, alter the product mix and expand output or services;

(c) Proposals for the introduction of superior technology, for training, for related local business opportunities and for employment.

111. Two important consequences of this approach are that (a) the bids need to be compared under a number of criteria and with a certain amount of flexibility, and (b) the tender process will not end with a "winner" but will produce a preferred bidder who will be invited for exclusive negotiation of a comprehensive contract. Under these conditions, advisory assistance from international agencies can be useful in enhancing the credibility of the choice made of the preferred bidder and in assisting the negotiation of the agreement. A case in point concerns an industrial privatization in Latin America, in which the Division assisted the Government to develop an evaluation framework that would enable the State enterprise to consistently compare proposals encompassing both business plans and financial terms for joint venturing a State asset.

112. For the same reasons, Governments should not necessarily predetermine the corporate structure in advance, for example by insisting on retaining a fixed level of state ownership. Similarly, the manner and timing of remuneration can be left flexible. However, any deferred payment arrangement should be entered into prudently, as the lessons of Chile's first and failed privatization show. Governments should try to define their interests in ways that invite private parties to propose corporate structures and financial arrangements that are attractive to interested investors.

113. One issue in determining corporate structure is an apprehension that loss of ownership may also mean loss of control. In principle, this apprehension is not a foreign investment issue per se because the issue arises regardless of whether ownership is foreign or local. It is seen, though, as more acute with foreign investors because of the resources and expertise they command.

114. This issue is focused most clearly on foreign involvement in "strategic" industries and in terms of sovereignty over natural resources.

115. The Division's long experience with foreign investment issues in both established and new business is that government ownership is rarely necessary to achieve regulatory control. Controls to achieve public objectives can be exercised through a combination of the regulatory framework applied to the industry, supported, if necessary, by contractual arrangements applied to individual enterprises.

116. This issue was discussed in the previous report on experiences gained in technical cooperation activities involving assistance in formulating negotiation strategies (E/C.10/1992/10).

C. Enterprise restructuring

117. Some of the best known cases of privatization have involved extensive operational and financial restructuring prior to divestiture. Clearly, a certain amount of legal restructuring needs to be done in converting statutory corporations to limited liability companies. It is not, however, so obvious that extensive business or financial restructuring, including new investment, must be performed before divestiture. Governments are not necessarily better able to undertake business restructuring than new private owners.

118. It can, however, be useful for a Government to obtain specialist assistance to indicate the expected value of an enterprise if it carries out certain business plans. The Division recently assisted in the initial stages of a hotel privatization by commissioning a prospectus that indicated the value to be expected from a fully renovated and market-repositioned property.

119. The principal effect of financial restructuring (for example, Government writing off its loans to State enterprises or assuming their debt or severance payment obligations) is to boost the ostensible price received in the divestiture. Apart from any contingent liabilities that Government can absorb at lower financial cost than private investors, restructuring does not effect the ultimate fiscal impact of the transaction. Liabilities will be accounted for in the offer price. However, Governments may judge that a substantial apparent sale price helps the public credibility of the privatization programme.

V. SUMMARY AND CONCLUSIONS

120. Many countries now have active privatization programmes. While a great many State-owned enterprises have been privatized in one form or another, especially in Latin America, the process is still at an early stage in most countries. Foreign investor participation has typically played a significant though not dominant part in privatization so far. Major transactions have reflected the strategic interests of foreign participants.

121. Privatization may deepen and widen foreign participation in the host country and thus raise some long-standing issues in foreign investment policy. The evidence suggests that privatization will not induce foreign participation on an economy-wide scale that is problematical. But it could lead to substantial foreign involvement in selected industries, including newly opened strategic industries. Some measures to limit the extent of foreign involvement in privatizations are evident. These may be partly to prevent crowding out of local private participation and partly a lack of confidence in exercising regulatory control without ownership. Attention should be given to foreign participation modes that are complementary to the development of domestic business capacity and local ownership.

122. Foreign participation can contribute to the goals of privatization by bringing skills, capital, markets and technology that are not available domestically. These resources will bring economic gains so long as they are deployed in market-oriented conditions supplemented by public interest regulation, where appropriate. In the latter sense, privatization needs to be accompanied by a strengthened, not reduced, role of Government.

123. Privatization programmes rarely target specific incentives to foreign participants over and above guarantees and protections generally available to the foreign investor. However, individual transactions offer considerable scope for non-discriminatory incentives that might be linked to performance requirements.

124. Much attention is paid to the pricing issues in the divestment of State interests. Economic loss can occur if State interests are divested below best available price. Prior valuation and competitive offers are necessary safeguards. Despite these safeguards, Governments may perceive that difficult economic conditions produce a climate in which State interests will be divested too cheaply to foreign investors. Any tendency to delay or limit privatization as a result would conflict with the important goal of rapidly putting State assets to more effective economic use.

125. Privatization programmes are highly demanding technical exercises. There is considerable need and scope for training and advisory support to the developing and transitional economies covering policy and regulatory review and subsequent implementation, enterprise reform, and development of supporting business disciplines and institutions, as well as in the design and negotiation of divestments involving foreign investors.

Notes

1/ See World Bank, Policy Research Bulletin, vol. 3, No. 4 (Aug.-Nov. 1992).

2/ As reported in Privatization: The Lessons of Experience (Washington, D.C.) World Bank, 1992.

3/ These issues are further discussed in M. Odle, "Foreign investment and privatization", Transnational Corporations, vol. 2 (forthcoming).

4/ There are no comprehensive statistics on the share of divestment receipts that are accounted for by foreign investors or their contribution to new capital formation. Similarly, there is no comprehensive statistical information on how important privatization-related foreign direct investment flows are in relation to total foreign direct investment, or detailed research on the extent to which privatization-related flows are additional to or partly offset by foreign direct investment in its traditional forms.

5/ A listing of recent privatizations involving transnational corporations is contained in World Investment Report 1992: Transnational Corporations as Engines of Growth (United Nations publication, Sales No. E.92.II.A.19), p. 87.

Notes (continued)

6/ The Division's privatization training workshops in developing countries involve government officials, managers of State enterprises and private sector participants. The workshops can provide simulation models so that participants can become sensitized to the diversity of issues involved in devising workable and publicly acceptable programmes.

7/ Estimates of the Transnational Corporations and Management Division; see World Investment Report 1992 ...

8/ "Hungary looks homeward for investors to partake the fruits of privatization", The Wall Street Journal, 11 December 1992.

9/ Far Eastern Economic Review (12 December 1991).

10/ World Investment Report 1992 ..., p. 87.

11/ World Bank, "Welfare consequences of selling public enterprises" (Washington, D.C., 1992).

12/ Ibid.